

CCH Expert Treatise Library: State Taxation of Income and Other Business Taxes, ¶8.03, Apportionable Income

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Under the Due Process Clause of the Fourteenth Amendment a state may only include income that is related to the unitary business of the taxpayer conducted within the state. "The linchpin of apportionability in the field of state taxation is the unitary-business principle."²⁵

States are not required to apportion income. But if a state wants to consider income that arises in some sense from activities outside the state, it must determine the income attributable to activities within its boundaries by apportionment. Therefore, in determining whether an item of income is apportioned or allocated, the preliminary question that must be answered is whether the item arises from the activities of the multijurisdictional unitary operations of the business entity that a state is considering in determining its tax. An item of income that meets the requirements of the unitary business principle can be apportioned, but it does not have to be.

UDITPA breaks income into two classes: business income, which is apportionable,²⁶ and nonbusiness income, which is allocable.²⁷ The question of whether a specific item of income is constitutionally apportionable is different than whether it is statutorily apportionable under UDITPA. The United States Supreme Court has said that UDITPA tracks in large part the unitary business principles enunciated in the United States Supreme Court's decisions.²⁸ Deciding whether an item of income is apportionable under UDITPA is a question of state statutory construction that does not present questions that the United States Supreme Court will review.

Several of the United States Supreme Court decisions and the business/nonbusiness income analysis under UDITPA will be discussed here. For a more detailed discussion of the cases see the discussion beginning under [¶6.01](#).

¶8.03[A] Apportionable Income Under United States Supreme Court Decisions

The Due Process and Commerce Clauses of the United States Constitution require that there exist some definite link or some minimum connection between a state and the object of a tax. A state's power to tax is justified by the protection, opportunities, and benefits a state confers on the activities of individuals and corporations. The unitary business principle, a longstanding theory, permits states to tax a corporation on an apportionable share of the multistate business conducted in part in the taxing state. The constitutional test for the existence of a unitary business focuses on functional integration, centralization of management, and economies of scale.

Under the United States Supreme Court decisions, income is apportionable under the U.S. Constitution if either

1. there exists a unitary relation between the entities or the in-state and out-of-state activities, or
2. the transaction arises operationally, rather than as part of an investment function.²⁹

For the tests for determining whether a unitary relation exists, see the discussion beginning at [¶6.01](#).

The operational test focuses on the objective characteristics of the asset's use and its relation to the taxpayer and its activities within the taxing state. The inquiry is whether the taxpayer's managers treated an asset as serving an operational function, as opposed to an investment function. For example, income earned on short-term deposits in a bank located in another state is apportionable income if that income forms part of the company's working capital. Under the operational function test, a state may apportion income even though no unitary relationship exists between payee and payor.³⁰ The state has the authority to apportion the income because the capital transaction serves an operational rather than an investment function. The relevant inquiry in determining whether an asset serves an investment or operational function "focuses on the objective characteristics of the asset's use and its relation to the taxpayer and its activities within the taxing State."³¹ The Court has noted that "a state may include within the apportionable income of a nondomiciliary corporation the interest earned on short-term deposits in a bank located in another State if that income forms part of the working capital of the corporation's unitary business, notwithstanding the absence of a unitary relationship between the corporation and the bank."³² The Court concluded that the apportionability of interest turns on whether the interest "forms part of the working capital of the [taxpayer's] unitary business."³³

¶8.03[A][1] Gain on Sale of Nonunitary Subsidiary

In *Allied Signal, Inc v. Director, Division of Taxation*³⁴ the Supreme Court, in a 5-4 decision in 1992, held that a state could not tax gain realized from the stock sale of a minority interest by a corporation located outside the state if the

minority interest served only an investment function and not an operational function. Of particular note is that all members of the Court upheld the unitary business principle as the controlling analysis for purposes of state taxation.

Allied Signal was the successor in interest to Bendix. Bendix was a multistate corporation domiciled outside New Jersey that did business in New Jersey. Bendix acquired a minority stock interest in a second corporation, ASARCO, which it sold at a gain. Under New Jersey statutes all the income of a corporation was apportionable. Bendix and the second corporation were unrelated business enterprises, each of whose activities had nothing to do with the other. Although the taxpayer corporation held two seats on the second corporation's board of directors, the taxpayer did not exert any control over the other corporation. The Court held that the New Jersey Supreme Court improperly concluded that it was constitutional to consider the gain realized on the stock sale as earned in the taxpayer's unitary business, relying in part on the fact that the proceeds were intended to be used in a bid to acquire a third corporation. The United States Supreme Court reversed because the two corporations did not operate as a unitary business.

The Supreme Court held that New Jersey's broad contention that all income of a corporation doing any business in a state is, by virtue of common ownership, part of the corporation's unitary business and apportionable cannot be reconciled with the constitutional limits on a state's power to tax value earned outside the state. The Court found that its precedents are workable in practice, and New Jersey's proposal would disrupt settled expectations in an area of law in which the national economy requires stability.³⁵ In addition the Court held, although the payee and the payor of income need not be engaged in the same unitary business as a precondition to apportionment in all cases, it is only necessary that a capital transaction serve an operational rather than an investment function. Finally, the Court held that it remains the case that to exclude income from an apportionment formula, a corporation must prove that the income was earned in activities unrelated to those activities conducted in the taxing state.

In this case, functional integration and economies of scale could not exist because the two corporations were unrelated business enterprises without any common activities. There was no centralization of management. The fact that the taxpayer acquired the stock pursuant to a corporate strategy of acquisitions and divestitures did not convert a passive investment into an integral operational investment. No substantive distinction exists between the all-encompassing business purpose test rejected by the Court in *ASARCO* and the state court's "ingrained acquisition-divestiture policy" approach. Moreover, the state court incorrectly relied upon the fact that the taxpayer intended to use the stock sale proceeds to finance the purchase of a third corporation, which might have operated as part of the taxpayer's unitary business. In addition, the stock investment, held over two years, did not constitute a short-term investment of working capital comparable to a bank account or certificate of deposit. Therefore, no unitary business relationship existed between the two corporations, and New Jersey could not include the gain realized on the stock sale in the taxpayer corporation's apportionable tax base.

¶8.03[A][2] Characterization of Dividends

Asarco Inc. v. Idaho State Tax Commission and *F.W. Woolworth v. Taxation and Revenue Department of New Mexico* were argued and decided the same day. Both cases involved the question of whether dividends received from foreign subsidiaries were apportionable income.

In *Asarco Inc. v. Idaho State Tax Commission*,³⁶ a 1982 case, the issue was whether dividends received from uncontrolled foreign incorporated subsidiaries were apportionable income. The subsidiaries were engaged in businesses related to the taxpayer's business, the mining of non-ferrous metals. One subsidiary sold a substantial portion of its output to the taxpayer, and two others were fabricators that used the taxpayer's metal products. None of the subsidiaries were unitary with the taxpayer because the taxpayer did not have controlling ownership. The Supreme Court held that a unitary business relationship between the taxpayer and the subsidiaries was necessary for treatment of the dividends as apportionable business income. Without this relationship, the dividends were nonbusiness income taxable only by the state where the taxpayer was domiciled. The Supreme Court did not define unitary business, but did reject a definition of the term that would permit nondomiciliary states to apportion and tax dividends if the business activities of the dividend payor had nothing to do with activities conducted in the nondomiciliary taxing state by the dividend recipient. The Supreme Court's analysis made no distinction between the use of the unitary business principle for purposes of combined reporting and its use for determining whether a particular item of income was business income.

In *F.W. Woolworth v. Taxation and Revenue Department of New Mexico*,³⁷ the issue was whether dividends received from controlled foreign subsidiaries engaged in the same line of business were apportionable income. The Court concluded they were not because the parent had the power to, but did not, exercise control over the subsidiaries and there were no intercompany transactions.

Read literally, *Asarco* suggests that nondomiciliary states cannot treat dividend and capital gains from the sale of stock as apportionable income unless the payor or underlying subsidiary is engaged in a unitary business with the recipient or

parent corporation. Commentators have criticized this result and suggested that the Court confused unitary income principles with combined reporting principles. In Justice O'Connor's dissenting opinion, she maintained that the Court had ignored the business advantages that accrued to ASARCO from its ownership of the subsidiaries in question. She further maintained that these advantages were more than sufficient to establish that the investments were part of a unitary business.

In *Allied Signal*,³⁸ the Supreme Court made clear that the unitary relationship between the parent and a minority owned subsidiary was not necessary for income received from the subsidiary to be subject to apportionment. What is required is that the transaction serves an operational rather than an investment function. The Court addressed the holding in ASARCO and stated that had the investment constituted an interim use of idle funds, which were accumulated for future operations, the income would have been subject to apportionment. In a dissenting opinion in *Allied-Signal*, Justice O'Connor stated that investment income could serve an operational function if it is "intended to be used by the time it is realized for the making of business' anticipated payments; for expanding or replacing plants and equipment; or for acquiring other unitary businesses that will serve the in-state business as stable sources of supply or demand, or that will generate economies of scale or savings in administration."

¶8.03[A][3] Gain on Sale of a Division

More recently the U.S. Supreme Court heard *Meadwestvaco Corp. v. Illinois Department of Revenue et al.*,³⁹ which dealt with the sale by the taxpayer of a division. Mead is headquartered in Ohio and is engaged in the paper business. In 1958 Mead bought Lexis, which was engaged in the business of providing access to electronic data bases (LexisNexis). Lexis headquarters were in Illinois. Mead sold Lexis as a division in 1994 for a gain in excess of \$1 billion. It did not report the gain on sale as apportionable business income in Illinois, but rather contended that the sale was allocable nonbusiness income (presumably allocable to Ohio).

The Illinois trial court found as a fact that the historic Mead paper business and the Lexis business were not unitary. It then applied a separate test asking whether Lexis had an operational relationship (as opposed to an investment relationship) to Mead, and it found that it did. That finding justified taxing the sale gain as the business income of Mead.

The Appellate Court of Illinois did not review the trial court's finding of nonunitariness but affirmed on an operational purpose analysis. The Illinois Supreme Court declined to hear the case. The constitutional issue presented to the U.S. Supreme Court was whether operational purpose was a separate test for apportionability and whether there was a sufficient connection between Illinois and the gain realized on the sale of Lexis to allow the gain to be included in apportionable income under the Due Process Clause of the U.S. Constitution.

The U.S. Supreme Court reversed the Appellate Court decision on the grounds that the lower courts had misunderstood the Supreme Court's precedents and had consequently applied an improper legal test. More specifically, the Court stated that "the state courts erred in considering whether Lexis served an 'operational purpose' in Mead's business after determining that Lexis and Mead were not unitary." The Court then explained that its "references to 'operational function' in *Container Corp.* and *Allied-Signal* were not intended to modify the unitary business principle by adding a new ground for apportionment."

The Supreme Court did not consider whether Lexis was unitary or whether the gain was otherwise apportionable, because the Illinois Appellate Court had not considered that factual question. The Supreme Court remanded the case back to Illinois on this issue and further proceedings. The case was subsequently settled without further judicial consideration.

¶8.03[B] Business Income Determination

UDITPA defines business income as "income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business."⁴⁰ The Multistate Tax Commission takes the position that an item of income is classified as business income if it meets one of two tests.⁴¹ There is a split of authority of whether the definition of business income consists of two tests or one test with the second clause beginning with "and includes" being a subset of the general definition.

¶8.03[B][1] Transactional Test

The first part of the UDITPA definition of business income is income arising from transactions and activity in the regular course of the taxpayer's trade or business. Every state that makes a distinction between business and

nonbusiness income accepts that this first part is appropriate. There appears to be little disagreement as to what transactions and activity are in the regular course of taxpayer's trade or business. Such transactions and activity occur with frequency, are normal ones, and might be generally described as routine, day-to-day operations of the business. Under the first clause (termed the transaction test) neither gain nor loss on the sale of business assets or the liquidation of a business, either in whole or in part, is considered income arising in the regular course of business.

¶8.03[B][2] Functional Test

The second part of the UDITPA definition of business income is income from property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations. The UDITPA definition introduces this second clause with the phrase "also includes." This language gives rise to the argument that this second clause is only a description of something included in the first clause.

Under this second part of the definition the analysis of gains or losses focuses on the asset and whether that asset was an integral part of the taxpayer's regular trade or business operations. Under the functional test, all income from property is considered business income if the acquisition, management, and disposition of the property are integral parts of the taxpayer's regular business operations, regardless of whether the income was derived from an occasional or extraordinary transaction.

Under the functional test, there is no requirement that the transaction giving rise to the gain or loss must itself occur in the regular course of the taxpayer's trade or business. Thus, income from a sale of assets that are integral parts of a business is business income subject to apportionment even if the sale arises from an extraordinary disposition of the property.⁴² While most income of a corporation is produced through repeated transactions that are covered by the transactional test, most of the cases dealing with the distinction between business-nonbusiness income involve the application of the functional test to an individual transaction involving a large amount of gain.

¶8.03[B][3] Origin of Business Income

UDITPA's distinction between business and nonbusiness income was included at the suggestion of a representative of the California Franchise Tax Board. The distinction arose from a series of California State Board of Equalization decisions.⁴³ As such, California's authorities on whether an item of income is apportionable, business income, or allocable nonbusiness income, should carry significant weight. "Business income" is derived from transactions and activity in the regular course of a taxpayer's trade or business, and includes income from tangible and intangible property, the acquisition, management, and disposition of which constitute integral parts of the taxpayer's regular trade or business. In effect, all income that arises from the conduct of a taxpayer's trade or business operations is business income. Income is presumed to be business income for allocation and apportionment purposes unless it is clearly classifiable as nonbusiness income.⁴⁴

California looks at the two tests, transactional and functional, as two separate tests to determine whether income is business income or nonbusiness income.⁴⁵ The California Supreme Court has held that analysis under both tests is required to determine the correct classification of income.⁴⁶ If either test is satisfied, then the income is apportionable as business income among California and the other states from which it is derived. If neither test is satisfied, then the income is fully allocable to the state of commercial domicile as nonbusiness income.⁴⁷ The transactional test identifies income as apportionable business income if the transaction or activity from which the income was derived occurred in the regular course of the taxpayer's trade or business. The functional test identifies income as apportionable business income if the acquisition, management, and disposition of the income-producing property was an integral part of the taxpayer's trade or business operations.⁴⁸

For a thorough discussion of California's perspective on business income see the case of *Hoescht Celanese v. Franchise Tax Board*.⁴⁹ In *Hoescht Celanese* the California Supreme Court held that a corporation's income from a reversion of surplus pension plan assets constituted business income apportionable to California. Hoechst Celanese Corp. ("Celanese") is a Delaware corporation that sells and manufactures chemicals, fibers, and specialty products. In 1947 Celanese put in place a qualified defined benefit plan and trust. Celanese, which conducted business operations in California, claimed tax deductions for its contributions on its federal and California tax returns. The plan was maintained as an inducement to retain current employees and to attract other qualified employees. Celanese appointed members of the administrative and investment committees that administered the plan and trust. The committees consisted of officers and non-officers of the corporation and they in turn appointed investment managers to handle the trust funds. The trust generated surplus assets through its investments. Celanese decided to recapture the surplus in order to thwart a potential takeover bid by dividing the pension plan into two separate plans, one of which was eventually terminated. All surplus assets of one of the plans and trusts reverted to Celanese. Celanese used the funds in

a stock redemption program.

In 1985, Celanese did not apportion any of the reverted income to California and was assessed franchise tax plus interest based on the income from the reversion. The Franchise Tax Board (FTB) denied Celanese's protest, and Celanese appealed to the State Board of Equalization ("SBE"), which ruled in favor of the FTB. Then Celanese filed a claim for a full refund with the FTB, arguing that the income from the reversion did not constitute business income and that apportionment of the income from the reversion to California violated the Due Process and Commerce Clauses of the U.S. Constitution. The FTB denied Celanese's claim; and, after a hearing, the superior court ruled in favor of the FTB. The court of appeals reversed the superior court's ruling and ruled in favor of Celanese. The FTB then appealed to the California Supreme Court.

The California Supreme Court examined subdivision (a) of California Revenue and Taxation [Code Section 25120](#) (identical to Section [1\(a\)](#) of UDITPA) to determine whether Celanese's income from the reversion was apportionable as business income. The court explained that [Section 25120](#) contained two clauses that define business income. The first clause established a transactional test and the second clause established a separate functional test. The court stated that Celanese's income from the reversion of surplus pension plan assets was apportionable as business income if it satisfied either test. Under the transactional test, the court explained, corporate income is business income if it arises from transactions and activity in the regular course of a taxpayer's trade or business. Because the reversion and the activities necessary to execute the reversion were one-time occurrences and were not part of Celanese's normal trade or business activities, the court found that Celanese's reversion of surplus pension plan assets failed to meet the transactional test. In addition, the court stated that the only transaction or activity that generated any taxable income for Celanese was the reversion itself.

However, the court found that Celanese's reversion created business income under the functional test, and therefore the income from the reversion was subject to California tax. The court explained that corporate income is business income under the functional test if the acquisition, management, and disposition of the income-producing property constitute integral parts of a taxpayer's regular trade or business operations. The court explained that Celanese created the income-producing property, the pension plan and trust, to retain employees and to attract new employees. Also, the court continued, Celanese funded the plan, retained an interest in the surplus pension plan assets, and exercised control over the plan through committees. The court stated that, although Celanese did not own or hold legal title to the pension plan assets, its control and use contributed materially to Celanese's production of business income by improving the quality of its workforce. The Court also dismissed the argument that Celanese did not have to report these pension assets in its financial statements. Accounting reporting requirements are not relevant to the determination whether the pension fund in a general sense was integral to the operation of the trade or business. Thus, the court determined that subjecting Celanese to California tax was fair and reasonable. Finally, the court addressed the constitutional claims raised by Celanese. The court found that subjecting an apportionable share of the reverted pension plan assets to tax was not a violation of the Due Process Clause of the Fourteenth Amendment or the Commerce Clause, because the income came from assets serving an operational rather than an investment function. Therefore, the California Supreme Court reversed the court of appeal. The United States Supreme Court denied cert.

Footnotes

25 [Mobil Oil Corp. v. Comm'n of Taxes of Vermont, 445 U.S. 425, 437, 439 \(1980\).](#)

26 UDITPA §§ [1\(a\)](#) and [9](#).

27 UDITPA § [1\(e\)](#) and [4](#).

28 Container Corp. of America v. Franchise Tax Bd., [463 U.S. 159](#) at 167 (1983).

29 Allied-Signal, Inc. v. Director, Div. of Tax'n, [504 U.S. 768](#) (1992).

30 *Id.* at 787.

31 *Id.* at 785.

32 *Id.* at 787-88.

33 *Id.* at 787..

34 Allied-Signal, Inc., as successor-in-interest to the Bendix Corp. v. Director, Division of Tax'n, [504 U.S. 768](#) (1992).

35 ASARCO Inc. v. Idaho State Tax Comm'n, [458 U.S. 307](#) (1982), or F.W. Woolworth Co. v. Taxation and Revenue Dep't of New Mexico, [458 U.S. 354](#) (1982).

36 [458 U.S. 307 \(1982\).](#)

- 37 [458 U.S. 354 \(1982\)](#)
- 38 [504 U.S. 768](#), at 792-93 (1992).
- 39 [553 U.S. 16 \(2008\)](#).
- 40 UDITPA § [1\(a\)](#).
- 41 UDITPA § 1(a)
- 42 Appeal of Borden, Inc., California State Board of Equalization, [77-SBE-007](#) (Feb. 3, 1977).
- 43 For a more complete discussion of this see James Peters and Benjamin F. Miller, "Apportionability in State Income Taxation: The Uniform Division of Income for Tax Purposes Act and Allied-Signal," 60 Tax Law. 58 (Fall 2006).
- 44 [Cal. Rev. & Tax. Code § 25120](#), [Cal. Code Regs. tit 18, § 25120](#)
- 45 CTS Keene, Inc., and CTS Corporation, California State Board of Equalization, [93-SBE-005](#), February 10, 1993.
- 46 Hoechst Celanese Corp. v. Franchise Tax Bd., [25 Cal. 4th 508](#), 106 Cal. Rptr. 2d 548; *cert. denied*, U.S. Sup. Ct. Docket No. 01-265 (2001).
- 47 [Cal. Rev. and Tax. Code §§ 25124](#) through [25127](#).
- 48 [Cal. Rev. and Tax. Code § 25120\(a\)](#)
- 49 *Hoechst Celanese*, *supra* at note 44.